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SUBJECT: GOC TIGHTENS CAPITAL CONTROLS AS PESO HITS
NINE-YEAR HIGH

REF: BOGOTA 1708

¶1. (SBU) SUMMARY. For the second time in six weeks, the GOC has tightened capital controls in an attempt to stem the steady appreciation of the Colombian Peso against the U.S. dollar. The peso's rise (14 percent since January 1) has significantly strained the competitiveness of Colombian non-energy exporters, ratcheting up pressure on the Uribe Administration to prevent job cuts. GOC officials insist the latest measures are intended only to curb speculative portfolio investment they believe has fueled the peso's rise to a nine-year high and not foreign direct investment (FDI). Most private sector observers say the controls will have no lasting effect in curbing the peso's appreciation, which remains linked more to global dynamics, high commodity prices and Colombian interest rate and spending policies. International banks have warned that the tougher controls will likely delay Colombia achieving investment grade status for its sovereign debt thereby perpetuating high debt service costs in the near term. END SUMMARY

If You Fail Twice, Try Again

¶2. (U) Citing the need to protect jobs in export industries hurt by the strong peso, in May 2007 the GOC put in place deposit requirements to control incoming foreign portfolio investment it blamed for the peso's rise. Following the continued steady appreciation of the peso over the last year, the Finance Ministry announced an expansion of the capital controls in late April 2008 as well as the launch of debt swaps in May 2008 to increase demand for U.S. dollars vis-a-vis the peso (reftel). After the additional measures only stanched the peso's appreciation for a few days, the Finance Ministry surprised markets on May 30 with a further increase in capital controls.

¶3. (SBU) Under the latest move, Colombia increased the six-month deposit requirement at the Central Bank on portfolio investment inflows from 40 percent of the investment value to 50 percent. Additionally, the GOC expanded the focus of the controls from foreign portfolio investment flows to include a requirement that FDI capital remain in Colombia for two years from the date of investment. (NOTE: Investors will still have the right to remit profits from their FDI without restriction. END NOTE.) Public Credit Director Viviana Lara told us that the latter move was intended to prevent foreign investors from masking portfolio investment as FDI in order to circumvent the controls.

GOC: Controls Necessary to Avoid Catastrophe

¶4. (U) In announcing the decision to a meeting of the Colombian Banking Association (Asobancaria), Finance Minister Zuluaga said the additional measures were necessary to protect employment and guarantee macroeconomic stability. In a separate interview with economic daily La Republica June 3, Zuluaga characterized the peso's revaluation as the greatest threat to the Colombian economy and said further rises against the dollar would be a "catastrophe" for Colombian exporters. While reaffirming GOC commitment to a free floating currency, Zuluaga stressed that the GOC is committed through capital controls, debt swaps and other mechanisms to mitigate the peso's climb. In public comments June 4, President Uribe defended the controls as a key instrument in differentiating FDI from speculative capital investment and said the GOC's had to move to protect employment generating export sectors such as flowers, bananas, and textiles.

Private Sector Increasingly Skeptical as Peso Climbs

¶5. (SBU) Since March 2007, portfolio investment in stocks has increased 77 percent to USD 2.8 billion and bond purchases have risen 110 percent to USD 1.8 billion. In the first four days of currency trading following the May 30 announcement the peso gained another 2.2 percent against the dollar underscoring the futility of the stronger controls. Asobancaria President Maria Mercedes Cuellar insisted to us that financial markets are too fluid for the measures to work effectively in Colombia. Contacts from the stock firms

Interbolsa and Corredores Asociados told us they recognize the political pressure behind the latest move, but said the decision will do nothing to address the peso's appreciation and only hurt Colombian competitiveness and send a negative message to international investors. Camilo Perez, Chief of Financial Research at Banco de Bogota, called the impact of the two-year requirement for FDI purely "psychological" since few, if any, foreign firms making direct investment expect to liquidate their investment in less than two years.

¶6. (SBU) Nevertheless, contacts such as National Association of Financial Institutions (ANIF) President Sergio Clavijo told us that he considered the stronger controls prudent in light of the threat posed by the peso's rise and the inflow of speculative capital. Clavijo asserted that without the measures in place over the last year the U.S. dollar would have fallen even further from the current rate of 1710 pesos to as low as 1500 pesos to a dollar.

External Factors Moving Market More than Controls

¶7. (SBU) All of our private sector contacts agree, however, that high Colombian interest rates, developments in the U.S. economy, high commodity prices, strong FDI inflows, and public spending policy in Colombia will continue to influence the peso more than the capital controls or announced debt swaps. For example, the May 27 announcement that the U.S. economy grew faster than expected in the first quarter of 2008 pushed the peso up 2 percent to a nine-year high against the dollar on expectations of stronger commodity exports to the U.S. market. Strong investment in the energy sector and high prices for oil, gas, coal, and coffee are also pushing up the peso. Meanwhile, Colombia recorded its second-highest FDI intake ever in 2007 (USD 9 billion). According to Proexport and National Hydrocarbon Agency (ANH) figures, 2008 announced FDI projects are expected to reach close to USD 10 billion--flooding the economy with more dollars. Finally, local economists have increasingly pointed to the GOC's elevated public deficit as a source peso appreciation. In the short term, most local analysts we talked to expect the dollar to fall below 1700 pesos. Central Bank Board Member Juan Mario Laserna told us he expects the peso to settle near 1800 pesos by the end of 2008--33 percent higher than in ¶2006.

Inflationary Pressures Putting Central Bank at Cross Purposes

¶8. (SBU) Coupled with the peso's appreciation, the GOC continues to struggle with stubbornly rising inflation. Consumer prices, driven by rising food and fuel costs, rose 0.93 percent in May--up from 0.71 percent in April and more than double analysts' previous consensus estimate for the month. The spike raised the 12-month inflation rate from 5.7 percent to 6.4 percent and likely dashes hopes of Colombia meeting its already revised inflation target of 4.9 percent for 2008 or even analysts' previous consensus estimate of 5.3 percent. The Central Bank has already raised its benchmark interest rate 375 basis points since April 2006 to 9.75 percent in an attempt to control inflation while the U.S. Federal Reserve and other central banks have cut rates to avert recessions. Laserna told us that prior to the May 23 Central Bank Board meeting, President Uribe contacted Board chair Jose Dario Uribe (no relation) to state the case for lower rates to spur the export sector, echoing private sector leader Luis Carlos Villegas' public call for lower rates. The Board maintained rates stable at the meeting -- Laserna commenting that Board staff models continue to show worrisome inflationary trends.

¶9. (SBU) Jorge Cortes Nieto, analyst at brokerage firm Corficolombia, underscored this interest rate differential as the primary reason for Colombia' investment inflow and consequent appreciation of the peso. He expressed pessimism about prospects for controlling the peso's rise until that margin closes. In light of higher than expected inflation figures for the first five months of 2008, local analysts increasingly expect the Central Bank to raise the rates on June 22 and, in effect, undercut the portfolio investment disincentive of the capital controls.

Likely to Delay Investment Grade as International Equity

Investors Sour

¶10. (U) Citigroup, Banco Santander and other international banks criticized the May 30 tightening and said it jeopardizes investment flows, risks liquidity in Colombian capital markets, and will delay investment grade status consideration (lost nine years ago). (NOTE: In early May, Citigroup had identified Colombia as the next country in Latin America to likely to receive investment grade. END NOTE.) Santander went further suggesting that international investor's interest may shift to Colombian firms with shares listed internationally. At the moment, only Colombia's largest bank, Bancolombia, is listed on the New York Stock Exchange. Partially privatized state-owned oil company Ecopetrol hopes to list by the end of 2008 and other major firms could follow suit if international investment flows into Colombia taper off.

¶11. (SBU) On June 3, Trade Minister Plata acknowledged publicly that the new controls could hurt Colombia's chances to achieve investment grade status on its sovereign debt this year. Minister Plata said the GOC would evaluate the impact of the new controls closely and lift them if they do not succeed in controlling the peso's appreciation. He did not, however, specify how long the GOC would take to review the controls. The GOC is keenly aware that the failure to achieve investment grade places Colombia at a disadvantage in competing for international financing with investment grade-neighbors Brazil, Chile, Mexico and Peru.
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